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FFIEC
Program Coordinator
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To Whom It May Concern:

I am writing to you on behalf of our firm, Regulatory Compliance Associates, Inc. (REGCOM) and our clients to comment on the 'Proposed Advisory on the Limitation of Liability Provisions in Audit Engagement Letters' as printed in the Federal Register, May 10, 2005.

Proposed Interagency Guidance

The **SUMMARY** as detailed regarding proposed guidance cites the unsafe and unsound use of limitation of liability provisions and certain alternative dispute resolution provisions in external audit engagement letters. The guidance, as proposed, would direct financial institutions' boards of directors, audit comments, and management to ensure that they do not enter into any agreement containing external auditor limitations of liability provisions with respect to financial statement audits. However, the **SUPPLEMENTARY INFORMATION** section expands upon the discussion to touch upon the level of regulatory concern, given increased usage of such language in certain financial institutions' external audit engagement letters that limit the auditors' liability. The section further notes the Agencies' opinion that such provisions may weaken an external auditor's objective, impartiality, and performance. If such is the case, the Agencies noted that such provisions raise safety and soundness concerns.

The **Background** section further notes that such provisions take many forms, and thereafter, details three such forms:

(1) Indemnification of the external auditors against claims made by third parties;
(2) Hold harmless clause or release of the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or
(3) Limitation of the remedies available to the client financial institution.

The **Comments** then explains that the FFIEC's publication of the proposed advisory on behalf of the Agencies named is an effort to seek public comment to fully understand the effect of the proposed advisory on the inappropriate use of limitation of liability provisions on external auditor engagements.

The request for comments specifically requests input on the following questions:

1) The proposed advisory, as written, indicates that limitation of liability provisions are inappropriate for all financial institution external audits.
   a. Is the scope appropriate?
   b. Should the advisory apply to financial institution audits that are not required by law, regulation, or order?
2) What effects would the issuance have on financial institutions' ability to negotiate the terms of audit engagements?
3) Would the advisory on limitation of liability provisions result in increased external audit fees?
   a. If so, would the increase be significant?
   b. Would it discourage financial institutions that voluntarily obtain audits from continuing to be audited?
   c. Would it result in fewer audit firms being willing to provide external audit services for financial institutions?
4) The advisory describes three general categories of limitation of liability provisions, and the following points are listed:
   a. Is the description complete and accurate?
   b. Is there any aspect of the advisory or terminology that needs clarification?
5) Appendix A of the advisory contains examples of limitation of liability provisions.
   a. Do the examples clearly and sufficiently illustrate the types of provisions that are inappropriate?
   b. Are there other inappropriate limitation of liability provisions that should be included in the advisory?
6) Is there a valid business purpose for financial institutions to agree to any limitation of liability provision?
7) The advisory recommends nullifying the limitation of liability provisions in 2005 audit engagement letters that have already been accepted, and the question is posed as to whether this recommendation is appropriate.

To provide insights, we polled a sampling of our clients for their feedback as well as requested each professional staff member take time to evaluate the proposal from **REGCOM's** perspective. The following comments summarize the insights and information provided by bank directors, presidents, senior financial institution team members, and in-house bank legal counsel, as well as points raised by **REGCOM** staff. Each point has a response with specific comments in italics below; this input based upon our firm's historical experience and potential future options.

REGCOM's Comments

- The proposed advisory, as written, indicates that limitation of liability provisions are inappropriate for all financial institution external audits with respect to:
  - Is the scope appropriate?
  - Should the advisory apply to financial institution audits that are not required by law, regulation, or order?

  The Proposed Advisory appears to be a duplication of what has already been stated in various regulatory materials, e.g., Regulatory Examination Handbooks, Outsourcing Internal and External Audit Issuances, Guidance Regarding Indemnification Agreements and Payment, as well as specific SEC guidelines. Furthermore, there are specific issuances that address the Board of Directors, or the Audit Committee thereof, and roles and responsibilities pertaining to maintaining an effective audit function.

  What is troubling here is the language of the proposed issuance that alternates between "external audits of financial statements" and "all external audit agreements entered into by financial institutions." The Agencies need to provide specific details and boundaries on what is a financial statement audit, and when an agency may agree to indemnification of an external audit firm. As presently stated, it appears that Agencies are indirectly trying to cover all external audits rather than just external audits of financial statements. The basis for this concern is noted in the proposal text that for the majority of financial institutions that would be covered by the proposed advisory, these limitations are already "unacceptable" under existing SEC rules and generally accepted auditing standards/principles/practices.

  If these limitations are already "unacceptable," why add additional regulatory burden and further cloud the issues/contracting relationships?

- What effects would the issuance have on financial institutions' ability to negotiate the terms of audit engagements?

  If the issuance is released as currently written, it will create confusion on what is covered, e.g., external financial statement audits, external audits that may impact financial statements such as reviews for reimbursement cases, or all external audits. Further, the terms of the audit engagements will have to change. Rather than working with clients to target specific areas or perform specialty audits, a firm will be required to utilize an all inclusive audit, with significant scope expansion, increased testing, and full disclosure of all findings. Judgmental decisions by external audit staff will be impaired out of fear of potential liability; accordingly there will be minimal flexibility on how much to review, what to detail as findings, what to put in the report to the Board, and to what extent, what to discuss with management. Firms will undoubtedly raise fees to cover expanded scope and testing, as well as to pay for significant increases in the firm's liability insurance costs, if the firm in fact can get such coverage.

- Would the advisory on limitation of liability provisions result in increased external audit fees?

  *As the present advisory is worded, and given the types of non-financial statement audit/consulting work performed by **REGCOM** (Examples: regulatory compliance reviews, CRA assessments, BSA/AML reviews, fair lending reviews and testing, loan review, disaster recovery testing, Regulation O reviews, policy and procedures reviews for general corporate governance, problem bank assistance, enforcement actions consultation), there is no way our firm would be in a position to continue. It is been our experience, and based upon our conversations with other similar type firms, the experience of others as well, that numerous insurance firms refuse a request to underwrite firms that deal with regulatory risk reviews or consulting; even when finally directed to Lloyds of London for coverage, coverage has been denied.*

  If this advisory is released and it requires elimination of any form of liability caps, thereby impacting our work scope and focus, we will be required to reconsider our business services. Other similar firms will likely be forced to undertake the same decision process.

  - If so, would the increase be significant?

    If it would be possible to obtain adequate coverage to cover all the potential forms of firm liability, the insurance premiums would be cost-prohibitive. Fees for compliance reviews for community banks would probably double, plus fees would have to be paid in advance to ensure the coverage is warranted with respect to work demand. In general, significant fee increases would be required to cover the insurance premium.

  - Would it discourage financial institutions that voluntarily obtain audits from continuing to be audited?

    Responses provided by ten different institutions indicated that, in general if fees double, it would diminish their willingness to hire firms for independent reviews of regulatory risk, loan review, fair lending, etc. Furthermore, unless required by law, many respondents indicated that they would forego future external regulatory risk-oriented reviews. For reviews that are required, e.g., independent BSA/AML reviews, the institution would be forced to either add staff to perform this service, or pass along the costs to customers in the form of significant fee increases.

  - Would it result in fewer audit firms being willing to provide external audit services for financial institutions?

    *Respondents indicated that management would undoubtedly have fewer firm choices to consider when outsourcing independent reviews. Independent firms such as **REGCOM** would be forced to make a business decision whether to continue to offer such services, and*

if so, how to pass along the significant liability insurances costs due to no indemnification or professional liability caps on work performed for an institution.

- The advisory describes three general categories of limitation of liability provisions, and the following points are listed:
  - Is the description complete and accurate?

    While the descriptions/examples are accurate, there are other ways to limit liability which have not been noted in the Appendix. Other methods are sometimes considered less forthright, and therefore, it would seem the advisory if released as written, would drive all parties to seek potentially less acceptable liability cap methods.

  - Is there any aspect of the advisory or terminology that needs clarification?

    One of the overall themes noted by respondents is the advisory is difficult to understand; while the summary suggests the issuance only will apply to financial statement audits, the language quickly broadens to all types of external audits and reviews. This is problematic.

- Appendix A of the advisory contains examples of limitation of liability provisions and the request for comments seeks input regarding:
  - Do the examples clearly and sufficiently illustrate the types of provisions that are inappropriate?

    For the ones described, yes it does; however, there remain other methods to accomplish basically the same purpose, e.g., standing contract order for defined services that will be billed to the institution to cover any liability costs absorbed by the vendor. Unfortunately, such a billing would be a ruse with no services and no deliverables.

  - Are there other inappropriate limitation of liability provisions that should be included in the advisory?

    As already noted, the issuances and regulatory guidelines currently exist, and therefore, should be adequately explained and enforced by regulators. Adding another issuance is not going to help; adding other examples will still not entirely address all the issues.

- Is there a valid business purpose for financial institutions to agree to any limitation of liability provision?

  - Periodically **REGCOM** clients are impacted by problems that are not clearly defined. If the institution is calling for assistance and wishes to engage an independent external firm to review and report on potential regulatory exceptions, internal fraud, problem assets, or problematic systems, as example, there are too many variables to either price the engagement and/or scope the work. Suppose, the institution subsequently after finding

out the problems, destroys materials, sues the firm, and/or suffers even greater liability when the regulators determine the institution may have done nothing to correct the problems, the directors and shareholders sue the external review firm for perhaps not catching one violation, not forcing immediate corrective action, or not fully reporting all findings. The potential risks far out-weigh the justification to do such work; either the work will be refused by external firms, and institutions will no where to turn, or the work will be over-priced for contingencies that might occur.

- The advisory recommends nullifying limitation of liability provisions in 2005 audit engagement letters that have already been accepted, and the question is posed whether this recommendation is appropriate.

  The recommendation is not appropriate for 2005, and if the advisory is finalized and issued, any effective dates should apply to the following year, e.g., 2006.

Summary

REGCOM has performed various types of regulatory reviews, undertaken targeted testing efforts, and provided numerous hours of consultative assistance to institutions under enforcement actions. Finalizing the proposed issuance will require re-evaluating whether this service may be offered in the future, and if it is marketed, how high must the fees be set to cover the potential liability costs.

Thank you for providing the opportunity to comment on this proposed issuance.

Respectfully submitted,

Jerry L. Miller

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